<u>Banking on Basel…Again</u>

By U.S. Senator Edward E. Kaufman

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Mr. President, it has been only two years since we had an extremely painful financial crisis that almost brought down our entire economy.

To try to address the root causes of the crisis, we are currently nearing completion of a long and arduous process to develop a comprehensive financial reform bill.

The world is watching to see how strong a bill this Congress will produce – and we need to show leadership. Yet, I fear that, instead of putting in place strong structural reforms as a model for other nations, we are deferring too much to the discretion of regulators who have failed in the past and to international negotiations – currently underway in Basel, Switzerland – that have all too often resulted in global standards that were the lowest common denominators.

Capital flows easily across borders, and so the U.S. does need to provide leadership and then produce harmonized global standards. Instead, I fear we are doing the opposite: we have hollowed out our national response so that we can negotiate with a free hand on the global stage – after Congress has showed the world that we lack the political resolve to impose hard measures.

This is why we have heard a common refrain that statutory requirements on capital or other prudential standards will tie regulators' hands during those international negotiations. We heard it before on the Brown-Kaufman amendment to restrict the size, leverage and risk of our megabanks; now we hear it on the Collins amendment.

Senator Collins' common-sense provision would ensure that bank holding companies and systemically significant nonbank financial institutions are subject to capital and leverage requirements as stringent as those that insured depository institutions face under existing prompt corrective action regulations. This provision would raise the capital bar for our largest financial institutions, requiring them to hold more committed and reliable forms of capital, namely common equity and retained earnings. As my colleagues will recall, it passed by voice vote during the Senate debate.

Now there is the threat that the Collins amendment might be eliminated for the sake of "international negotiations." Mr. President, I fear this is a recipe for a global race to the bottom, for two reasons. First, a tepid response by the United States may also undermine other countries' consideration of tough reform measures. For example, the U.K. is studying whether to break up their megabanks, but some in the U.K. have suggested that since the U.S. isn't taking this preemptive action, the U.K. won't do it either.

And second, some countries' regulators appear wedded to the status quo, and we are only reinforcing the impression that tough measures are not needed. Remarkably, only weeks before European governments and the IMF cobbled together an almost $1 trillion bailout of European megabanks, one French government official stated: "The situation is completely different here and the system that was in place has not worked badly and does not need to be overhauled." Regulators from Germany, France and Japan, among others, are opposed to having a leverage requirement and a more strict definition of what constitutes capital.

Leaving aside the opposition of many countries to the very concept of a leverage capital requirement, there are those who still indicate that the quantitative requirement must be set through the Basel negotiations. In fact, Treasury Secretary Geithner has said that "by the end of this year, we will negotiate an international consensus on the new ratios."

How does it strengthen our negotiating hand for the Congress to have failed to enact hard rules? Moreover, it is tough to imagine how we can set a number on leverage when we don't even have agreement on how to measure leverage since the U.S. follows GAAP accounting standards while the rest of the world follows IFRS. It is unlikely that we will have uniformity or even harmonization of these rules for many years, if we ever will at all. While the accounting standard issue is often overlooked, it should go without saying that it is a more basic and first-order problem.

Most importantly, for what are we negotiating? The history of international capital standards is that of colossal failures – Basel I, Basel II, and now, Basel III. Instead, we had a sovereign banking failure and should be establishing a sovereign solution. If other countries want to permit their banks to become risky and fail, such as what Europe may soon be facing due to the European debt crisis, then let them learn then the hard lessons America already has learned.

Let me briefly review the history of the Basel accords, which should stiffen the resolve of the conference negotiators to include measures that will prevent another financial crisis caused by U.S. megabanks.

Basel I

The Basel I Accord was a crude apparatus that established numerical requirements for the amount of capital that banks need to set aside based upon how risky the assets on their balance sheets were perceived to be. Different types of loans and assets were lumped into risk buckets. Some received lower risk weights, while others received higher risk weights. However, those weightings were arbitrary determinations that didn't even take into account basic risks - most notably credit risk - associated with loans and other financial assets that banks hold.

Under the Basel I system, a bond issued by a blue-chip AAA company like Johnson & Johnson would have had a much higher risk weight than a subprime stated-income loan, a loan to Greece, or a loan to Lehman Brothers. Not surprisingly, banks were able to easily game – or arbitrage – these capital requirements in a way that generally increased their risk profile. Banks were able to "cherry pick" high-risk, and therefore, high-return, assets that had low capital requirements because of the risk bucket in which they were placed. Banks also got around the Basel I requirements by shifting more assets off their balance sheets.

Basel II

The Basel II Accord, which was agreed to in 2004, was the culmination of several years of negotiations. While it was intended to address the flaws of Basel I by making capital requirements more risk sensitive, it actually created bigger problems.

Most notably, the Accord's complexity and sophistication masked a deregulatory philosophy that sought to make determinations on capital adequacy dependent on the judgments of rating agencies and, increasingly, the banks' own internal models. By outsourcing their regulatory responsibilities to the banks that they were supposed to regulate, bank regulators were making an implicit admission that the size and complexity of the megabanks had exceeded their comprehension.

Unfortunately, complex capital standards that rely upon banks' own internal models pose serious problems for any democratic nation that prizes accountability and transparency. In his book *Banking on Basel*, Federal Reserve Governor Daniel Tarullo provides an exhaustive account of the Basel II capital accord that specifically questions the accord's decision to base capital standards on the internal ratings of banks. Tarullo indicates that the "very complexity of the [accord's] approach gives banks more opportunities to manipulate, or make mistakes during, calculation of their capital ratios."

Even more troubling, Governor Tarullo noted it would also be nearly impossible for any independent auditor or examiner to identify failures and forbearance on the part of regulators. To that point, he states "it may be extremely difficult for an independent entity such as the Government Accountability Office to reconstruct the series of decisions and judgments that went into the creation and supervisory assessment of the credit risk model." Given that, how will we in Congress be able to hold either the megabanks or their regulators accountable?

By virtually all accounts, the Basel II Accord was a complete failure. The Basel Committee itself estimated that it reduced capital for some banks by as much as 29 percent, at a time in which regulators should have been ramping up capital and other prudential requirements upon banks.

By trying to tie capital requirements to so-called "risked-based" measurements, the Federal Reserve – the main driver of the Basel process – apparently hoped to eliminate the basic leverage requirement. In fact, former Fed Governor Susan Bies told banks that "the leverage ratio down the road has got to disappear." Fortunately, despite the Fed's objections, Basel II has not been implemented in the U.S., in large part due to concerns that it would disadvantage smaller community banks that did not have the resources and wherewithal to make investments in supposedly advanced risk models.

It was, however, applied to European banks. Unconstrained by a basic leverage capital ratio, many of these banks went on to arbitrage the Basel requirements by gorging on AAA-rated bonds backed by subprime mortgages, not to mention the sovereign debt of highly indebted Eurozone countries like Greece and Spain. The result has been hundreds of billions of dollars of losses followed by both explicit and implicit bailouts by E.U. governments.

The Accord was also effectively applied to investment banks like Lehman Brothers and Goldman Sachs, which had precarious and explosive business models that utilized overnight funding to finance illiquid inventories of assets. These institutions were nominally regulated by the SEC, which had no track record to speak of with respect to ensuring the safety and soundness of financial institutions. The Commission allowed these investment banks to leverage a small base of capital over 40 times into asset holdings that, in some cases, exceeded $1 trillion.

Basel III

Of course, in the wake of the most recent crisis, the same failed regulators now tell us that, this time, they have learned their lesson and will develop a new agreement that will address the deficiencies of the last one. But what reasons do we have for thinking that will be true?

Assistant Treasury Secretary Michael Barr notes that regulators are now pushing for new global capital standards that will be "more robust, higher and better quality, less pro-cyclical, and include global agreement on a leverage ratio." But the megabanks are already developing new ways to arbitrage as well as weaken the global capital standards to which Secretary Barr refers. In other words, they are finding ways to gut and go around the rules before they are even finalized.

What's more, many of the regulators involved in the discussions inspire little confidence. Christian Noyer, the governor of the Bank of France and the new Chairman of the Bank of International Settlements, the entity that oversees the Basel rulemaking process, indicated, that the new rules "shouldn't undermine the business model of banks which have perfectly withstood the crisis." Given that the same Bank of International Settlements estimates that eurozone banks have two-thirds of the exposures to the most fiscally imperiled European countries – Greece, Ireland, Portugal and Spain – it is not clear to which banks Governor Noyer is referring.

As the *Financial Times* notes, France, Germany and Japan are "more attached to the pre-eminence of the current risk-based approach and wants the leverage ratio to have a much less important role in governing banks' balance sheets." In effect, they are pushing for the status quo of Basel II, which has been an unmitigated disaster. After the multiple trillions of dollars worth of public funds expended on megabank bailouts, it seems amazing that many regulators would like to maintain a system where the largest banks effectively regulate themselves.

But U.S. regulators are not immune to the defense of existing regime. As the *Wall Street Journal* reports, "some U.S. government officials are fighting what they view as an anti-American proposal that would prevent banks from counting as part of their capital cushion a specific type of security favored by U.S. banks known as a trust-preferred security." In other words, we have unnamed U.S. regulators that are fighting against Senator Collins' amendment in international negotiations.

The current state of international capital negotiations gives little comfort to those who would like to see fundamental structural reforms to address the problem of "too big to fail."

Conclusion

I am in favor of international negotiations to harmonize financial regulatory standards. These negotiations should not, however, preclude the Congress from setting statutory floors. They should never result in the abdication of our sovereign powers and responsibilities.

I therefore agree with the sage thoughts of former Federal Reserve Chairman Paul Volcker when he said that while "good things may come out of" the Basel process, "it is not structural change." In his view, and in mine, we need to do both.

Instead of trusting our financial stability solely to unelected financial guardians, in this country and abroad, Congress should legislate structural and fundamental reforms that preemptively address the persistent problem of "too big to fail." Senator Collins' provision is but one example of that. There is also Senator Lincoln's proposal to require swap dealers to be spun off and separately capitalized from insured depository institutions; a strong Volcker Rule ban on proprietary trading at banks, as proposed by Senators Merkley and Levin.

Without transparency and accountability, a democracy cannot function. That is why we still need the statutory standards on the leverage as well as the size of these megabanks. While some technocrats may say that they are blunt tools, I say that that is precisely the point. They will not only provide a sorely-needed gut check that ensures that regulators don't miss the forest for the trees when assessing the capital adequacy of a financial institution, they will also provide a basic means to ensure accountability in the performance of government officials.

We cannot afford another meltdown and the American people – and, indeed, the rest of the world – are looking to Congress to take steps to ensure that that does not happen. By adopting these fundamental reforms and preemptive measures, Congress will go a long way towards protecting the American people from future bailouts. It will also be providing global leadership, demonstrating to the rest of the world that fundamental reform of our financial system doesn't rest upon the decisions of unelected technocrats whose grand designs brought our financial system to the brink.